

Why Are Canadian Firms' Shares Discounted?

Canadian listed firms' market-to-book ratios are ten percent or more below those of similarly sized US listed firms in the same industries.^{1 2 3} Similar discounts are present in Canadian firms' PE ratios, Q ratios, and other valuation measures. Given the close similarity and integration of the two economies, this is an intriguing anomaly dubbed "the Canada discount puzzle."

My research is about why shareholders value Canadian firms less highly than they value very similar US firms? Previous work confirms the existence of a Canada discount, but remains somewhat ambiguous about what causes the discount. One line of previous work argues that many Canadian firms have corporate governance problems associated with entrenched controlling shareholders – often politically powerful business families.⁴ Current issues surrounding the governance of the family-controlled Bombardier Corp. may fit under this heading. Other implicated factors include dual class shares, voting caps, or intercorporate equity block holdings. Other possibilities, also related to possible corporate governance shortcomings in Canadian firms, include lower R&D spending, the deadweight cost of exchange rate unpredictability, different regulatory burdens, different tax burdens, and others.

My doctoral thesis is to use an unprecedentedly comprehensive (in number of years and number of firms covered) panel database of Canadian firms to explain why the Canada discount exists. I am connecting firms' accounting items from the *Globe and Mail* Report on Business (ROB) database with stock prices from the Canadian Financial Markets Research Centre (CFMRC), macroeconomic data from Thomson Reuters Datastream and the Bank of Canada, and information about controlling shareholders from Statistics Canada's *Directory of Intercorporate Ownership* and historical editions of the *Financial Post* 500 listings.

This will let me explore how the Canada discount varies (or does not vary) across years, industries, and firms' varied corporate governance regimes. If the discount changes abruptly when different regulations come into effect, this would implicate regulatory differences between the two countries. If the discount varies in synch with macroeconomic factors, for example exchange rate volatility, the macroeconomic environment would be implicated. If the discount is larger for family-controlled firms, this would suggest that shareholders devalue firms whose directors are less free to act independently.

Preliminary results show the discount has worsened since previous studies looked at it, and suggest governance shortfalls, some possibly made worse by macro-economic factors. My further work should help isolate the causes of the Canada discount. This would help directors (or shareholder activists groups) better identify and correct genuinely important governance problems. Correcting these problems would increase Canadian share prices, thereby increasing investors' portfolio values and, by increasing IPO valuations, making Canadian stock markets better places for entrepreneurs to list.

¹ King, Michael & Dan Segal. 2003. Corporate Governance, International Cross-Listing and Home Bias. *Canadian Investment Review* 16: 8–19.

² King, Michael & Dan Segal. 2008. Market Segmentation and Equity Valuation: Comparing Canada and the United States. *Journal of International Financial Markets, Institutions and Money* 18: 245–258.

³ King, Michael & Dan Segal. 2009. The Long-Term Effects of Cross-Listing, Investor Recognition, and Ownership Structure on Valuation. *Review of Financial Studies* 22: 2393-2421.

⁴ Morck, Randall, David Stangeland & Bernard Yeung. 2000. Inherited Wealth, Corporate Control & Economic Growth: The Canadian Disease? In Randall Morck, ed. *Concentrated Corporate Ownership*. National Bureau of Economic Research & University of Chicago Press, 319-69.